Opportunity Zones:

Exploring the Second Tranche of Regulations, the Role of Government, and Ensuring Equitable Development

by Kody Glazer

In our December Journal, the Florida Housing Coalition provided an overview of the new Opportunity Zones (OZ) incentive. We discussed how the program functions to attract investment into low-income communities and what the program means for affordable housing and community development. At that time there was only one batch of proposed regulations from the Treasury Department and there were many unknowns about the program: Would projects in OZs serve existing communities or would they displace residents? What role would local government play in OZs? How would OZs interact with other programs such as the Low-Income Housing Tax Credit, New Markets Tax Credit, Brownfields, and other initiatives? How would OZ projects be structured financially?

Now, six months later and an additional set of rules published on April 17th, some of the same questions remain while others have been answered. Overall, we now have a better sense of what the program will entail and how community advocates can be involved. From an affordable housing and community development perspective, it is still up to investors, local governments, philanthropies, foundations, bankers, community advocates, and others interested in equitable development to ensure that the Opportunity Zones incentive benefits the low-income communities the program was designed to serve.

The Opportunity Zones program is proving to be the most hands-off federal initiative designed to spur economic development in low-income communities over the past 50 years. Current IRS regulations do not require OZ projects to meet affordable housing requirements or other reporting standards that have characterized Enterprise Zones, the Low-Income Housing Tax Credit, the New Markets Tax Credit, and similar past programs. The regulations, to this point, have been investor-centric and lack meaningful guidance as to how to engage the communities within OZs. As a result, it is still up to well-intentioned, community-centric parties to make sure that the program works effectively from an equitable development standpoint.

Role of Local Government

In February, the Florida Housing Coalition hosted a seminal webinar on the role of local government in the Opportunity Zones incentive. That webinar, sponsored by PNC Bank, is available on the Opportunity Zones section of our website (www.flhousing.org/opportunity-zones). To maximize the potential of OZs, local governments can act as a matchmaker, investment promoter, and steward of community resources. At its core, local government can be a place where all members of the community come together to plan for revitalization and equitable growth. To help realize these plans, local governments can work to attract investment into Opportunity Zones, connect interested parties to plan for community-centric projects, and ultimately utilize their land use authority to plan and prepare for OZ investment. The dozens of connections to local governments established following our Webinar demonstrates the degree to which our local government partners recognize the role they can fill in OZs.

Second Tranche of Regulations

On April 17, the Treasury Department released the second tranche of OZ guidance. The 169-page document contains guidance regarding asset tests, fund operation, real estate treatment, and other key issues. This Article highlights those areas relating to affordable housing and community development.

1. Gross Income Test for Operating Businesses

For an investor to receive the favorable tax treatment under the program, the investor must deploy capital gains into a Qualified Opportunity Fund (QOF). A QOF is any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property and qualified opportunity zone businesses. To be a QOF, the entity must hold at least 90% of its assets in qualified opportunity zone property or businesses. To be a Qualified Opportunity Zone Business, the entity must be a trade or business that holds at least 70% of its assets in an Opportunity Zone. Further, 50% of the business's gross income must be derived from active conduct in an OZ.

The second tranche clarifies what is meant by "active conduct" within an OZ. Some commenters were concerned that a stringent definition would bar businesses from creating products within an OZ and then shipping them to destinations outside of a designated OZ. If "active conduct" was confined to creating and selling goods solely within an Opportunity Zone, a start-up tech business that shipped goods throughout the country, for example, would be deterred from setting up shop in an OZ.

Under the second tranche of guidance, a business can meet the "active conduct" requirement through three safe harbors and a facts and circumstances test. The first safe harbor requires that at least 50% of the services performed (based on hours) are performed within an OZ. If a business can meet this test, it qualifies as a Qualified Opportunity Zone Business. Second, if a business can show that at least 50% of the amount paid for services performed are within an OZ, it also qualifies. Third, a trade or business can satisfy the active conduct test if the tangible property of the business within an OZ and the management or operational functions performed are each necessary to generate 50% of the gross income of the trade or business. If a business cannot meet one of these three tests, it can still meet the active conduct test if, based on all the facts and circumstances, at least 50% of the gross income is derived from active conduct within an OZ.

2. Leased Property

The Opportunity Zones statute states that OZ property must be "purchased" for parties to receive favorable tax treatment. The second tranche of regulations clarifies that one may "purchase" property by either owning it or by leasing it. Leased tangible property may be treated as qualified opportunity zone business property as long as the lease was entered into after December 31, 2017 and as long as substantially all of the use of the property is in the OZ during at least 90% of the period for which the business leases the property.

Improvements made by the lessee satisfy the original use requirement and are considered purchased property under the statute; QOFs can deploy capital to businesses who lease their property. The lease must be a "market rate lease" and if the lessor and lessee are related, the regulations specify certain requirements.

The leasing provisions in the second tranche of regulations are particularly intriguing from a community development perspective. A chief concern for many community advocates prior to the regulations centered on potential displacement concerns not only for residents but also for existing businesses, many of which lease operating space in small commercial plazas and main street commercial centers. The lease provisions in the second round of regulations permit existing businesses to benefit from the OZ incentive without having to purchase space of their own.

3. Working Capital Safe Harbor

The first batch of guidance offered a working capital safe harbor which gave QOFs a 31-month window to deploy capital into OZs as long as the QOF followed a written plan as to how the capital gains were to be deployed for the acquisition, construction, and/or substantial improvement of tangible property. The second batch expands this safe harbor to include planning for the development of a new trade or business. Further, the new regulations state that exceeding the 31-month window does not violate the safe harbor if the delay is attributable to waiting for government action pertaining to the investment.

In practice, this means that a QOF does not need to deploy all the capital gains into a project by the end of 2019 to receive the most favorable tax treatment or to begin deferring capital gain taxes. Provided the QOF follows a written plan as to how it will deploy initial capital gain investments over time, investors can begin to reap the tax benefits once they place capital gains in a QOF.

Those even superficially familiar with real estate understand that development can be challenging and time consuming. These working capital safe harbor provisions advance the interests of real estate in the OZ incentive by offering flexibility and time to conduct predevelopment activities before the incentive's capital deployment deadline kicks in.

4. Vacant Property

To qualify as opportunity zone business property, the original use of the property must commence with the QOF or the QOF must substantially improve the property. The second tranche holds that where a building or other structure has been vacant for at least five years prior to being purchased by a QOF or a qualified opportunity zone business, the purchased structure will satisfy the original use requirement. This requirement is important for adaptive reuse projects, such as the redevelopment of shopping center properties into mixed use developments for affordable workforce housing and businesses and other projects that return abandoned structures to valuable uses.

5. Unanswered Questions

Conspicuously absent from the second tranche of guidance is any reference to reporting requirements or performance standards. There are no requirements for OZ projects to meet certain goals or report on items such as jobs created, affordable housing units developed, amount of investment in locally-owned businesses, or other community-centered metrics. This means the Opportunity Zones program still has the potential to simply be a tax-break for those with capital gains without regard to equitable development or alignment with community goals. Without guardrails from the federal government in regard to community benefit, it is up to local and state governments, community leaders, and well-intentioned investors to ensure that OZ projects benefit the residents within designated OZs.

We should note that the IRS did issue a separate request for information on data collection and tracking for qualified OZs. The IRS offered a 30-day window for comments, ending on May 31, 2019. Within the text of the RFI, the IRS suggested comments related to measures of economic development like job creation and poverty reduction. While these objectives are valuable, especially reducing poverty, the IRS missed an opportunity to define other metric categories, like the number of affordable housing units created by a QOF, or the number of new jobs generated through development of affordable housing.

Under current regulations, for an existing use to qualify as opportunity zone business property, the QOF must substantially improve the property. However, in determining substantial improvement, the regulations only consider improving the value of improvements on the land – not the land itself. Environmental cleanup is unique in that it requires the improvement and replenishment of the land underneath buildings. Further, the nature of this cleanup would require a timeframe longer than the 31-month working capital safe harbor that currently exists. The regulations in their current form do not contemplate environmental remediation of land. To maximize the potential of OZs, the costs of environmental remediation and the unique nature of the Brownfields program as a tool for development in lower income areas, especially around old industrial sites, seems to be a missed opportunity for making the most of the Opportunity Zones program.

Federal Government Role

In recent months, the federal government has taken a more proactive role in the Opportunity Zones incentive. In December 2018, Executive Order 13853 established the White House Opportunity and Revitalization Council. The Council consists of representatives from all the federal cabinet agencies and other federal offices. A mission of the Council is to work across agencies to assess the actions each agency can take to prioritize or focus Federal investments on distressed communities, including OZs. The Council is also tasked with recommending policies and evaluating methods by which to streamline administrative burdens, prioritize OZs in federal actions, and aid community-based applicants. The Executive Order directed the Department of Housing and Urban Development (HUD) to provide the funding and administrative support for the Council and directed the HUD Secretary to designate an Executive Director.

In April of 2019, HUD published a request for information seeking input on how it can act to encourage public and private investment to maximize the beneficial impact of OZs. Specific questions included: what tools can HUD provide to make local communities, investors, and other stakeholders more aware of the full range of Federal financing programs and incentives available to projects located in OZs? What policies could HUD implement that would help community-based applicants identify and apply for relevant federal resources?

Secretary Ben Carson has proven to be an outspoken advocate for Opportunity Zones – appearing at dozens of OZ-related conferences across the country. In May, it was announced that the Federal Housing Administration (FHA) would provide a set of incentives to encourage affordable multifamily property owners to invest in OZs. The FHA announced it would reduce application fees for certain affordable housing programs in OZs and will designate a team of underwriters to expedite review of applications. Based on the work of HUD and the White House Opportunity and Revitalization Council, similar incentives are expected.

There is some concern in Washington evidenced by a bipartisan coalition of Senators who introduced a bill in May that would require the Treasury Department to collect data on the number of opportunity funds created and the impact the funds are having on underserved communities. The goal of the bill is to increase transparency and help Congress assess the impact OZ investments have on job creation, poverty reduction, and support for new businesses.

Philanthropy & Foundation Involvement

Because the federal government is taking a hands-off approach when it comes to how projects within OZs are to benefit existing communities, it is up to well-intentioned persons with capital gains to utilize the initiative for community good. The Florida Housing Coalition is working with philanthropy and community foundations to get involved in Opportunity Zones.

Community foundations are in a great position to maximize the goals of the OZ incentive. Not only can community foundations involve existing low-income communities in the development process, they can align persons with capital gains with beneficial projects. These organizations can act as the middleman and connect investors, community leaders, philanthropists, and other stakeholders to develop localized OZ strategies for equitable development. Investors with a vested interest in the success of their local communities may be the greatest asset in shaping the success of OZs.

Conclusion

The Opportunity Zones incentive is an ideal source of capital for building and maintaining long-term affordable housing. Impact investors, local philanthropists, and other well-intentioned persons with capital gains can deploy capital into affordable housing projects within OZs and in ten years or later, recoup tax-free appreciation on the sale of their interests in the affordable housing project. This incentive structure, if done properly and in coordination with local communities, can bring much-needed capital to historically underserved communities and be a win-win for both lower-income individuals and investors. Community-minded philanthropists can recycle their tax-free appreciation and re-invest in OZs and other low-income areas for years to come.

Education is needed to shape the success of the program. Many residents living within OZs may not know they are in an OZ at all – leaving them vulnerable to the possibility of displacement from new development. Policymakers, philanthropies, individuals with capital gains, and existing businesses within OZs may be unaware of the incentive itself or how it can be utilized to benefit low-income communities. It is essential that low-income advocates continue to educate and engage with local governments, community leaders, and other interested parties to utilize the OZ incentive for equitable development. The Florida Housing Coalition is available to assist the public and private sector to ensue equitable development in Opportunity Zones. HNN

KODY GLAZER

Kody Glazer *is the Legal Director with the Florida Housing Coalition, specializing in local and state governmental affairs, fair housing, land use, and environmental law. He graduated Magna Cum Laude from the Florida State University College of Law, where he served concurrently on the Law Review and the Journal of Land Use & Environmental Law.*